

CALIFORNIA DENTAL NETWORK, INC.

Notes to Financial Statements (continued)

1. Organization

California Dental Network, Inc. (the “Company”), a wholly owned subsidiary of Pacific Dental Network, Inc. (the “Parent”), was incorporated in the State of California on March 5, 1987 under the former name of Alternative Dental Care of California (“ADCC”).

The acquisition of ADCC by the Parent in May 1998 was accounted for by the purchase method of accounting. Total cash consideration of \$275,000 was paid in exchange for purchase of all issued and outstanding shares of ADCC common stock. ADCC’s assets were comprised of a \$50,000 restricted cash deposit and a Knox-Keene health plan license. There were no liabilities at the date of purchase. Purchase consideration in excess of the \$50,000 ascribed to the cash deposit was recorded as goodwill in the amount of \$225,000, which is included in the accompanying balance sheets as intangible asset.

The Parent has committed to fund continuing operations of the Company, if necessary, through December 31, 2004.

2. Nature of the Business

The Company is licensed by the California Department of Managed Health Care (“DMHC”) under the Knox-Keene Health Care Service Plan Act of 1975 (the “Act”), as amended, to offer dental Health Maintenance Organization plans to groups and individuals throughout the State of California. The Company's plans are marketed by independent insurance agents and offer their members a range of specified services through pre-approved dental offices.

3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of the Company's financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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Notes to Financial Statements (continued)

3. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity date of three months or less to be cash equivalents.

Prepaid Capitation

Capitation payments made by the Company to providers are recorded as prepaid capitation and expensed in the period that members are entitled to services.

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed on a straight-line basis over estimated useful lives of three to five years.

Restricted Deposits

The DMHC requires specialized health care service plans, licensed under the Act, to maintain a restricted cash deposit of \$50,000. The restriction is evidenced by an assignment to the director of DMHC. At December 31, 2002 and 2001, this amount is in a money market fund account, which is stated at cost that approximates fair value, yielding approximately 6% annually.

Intangible Asset

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*, which require that the purchase method of accounting be used for all business combinations initiated after September 30, 2001 and prohibit the use of the pooling-of-interests method. SFAS No. 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Companies are required to evaluate all existing goodwill for impairment yearly by comparing the fair value of each reporting unit to its carrying value at the Balance Sheet date. As of December 31, 2002, management has no indication that there has been impairment of its intangible asset.

3. Summary of Significant Accounting Policies (continued)

Revenue Recognition

Prepaid premiums collected by the Company for patient care services are recorded as deferred premium revenue and recognized as income in the period for which the member is entitled to services.

Income Taxes

The Company accounts for income taxes based on the standards in Statement of Financial Accounting Standards ("SFAS") No. 109, *Accounting for Income Taxes*. SFAS No. 109 is an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Measurement of the deferred items is based on enacted tax laws. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amount expected to be realized.

The Company files a consolidated tax return with the Parent and accounts for income taxes as if it filed on a separate return basis.

Reclassifications

The 2001 financial statements have been reclassified to conform to the 2002 presentation.

4. Fixed Assets

Fixed assets consisted of the following as of December 31:

	<u>2002</u>	<u>2001</u>
Furniture and equipment	\$ 43,436	\$ 39,795
Leasehold improvements	<u>665</u>	<u>665</u>
	44,101	40,460
Less accumulated depreciation and amortization	<u>(22,761)</u>	<u>(13,614)</u>
Fixed assets, net	<u>\$ 21,340</u>	<u>\$ 26,846</u>

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Notes to Financial Statements (continued)

5. Subordinated Note Payable to Parent

The Company has a subordinated note payable (the "Note") to the Parent in the amount of \$307,000 and \$287,000 at December 31, 2002 and 2001, respectively. The Note was obtained to bring the Company into compliance with its tangible net equity ("TNE") calculation required by the DMHC. Amounts are not payable if such payments would cause the Company to be out of compliance with TNE requirements. The Note bears interest at prime plus 2% per annum (an aggregate of 6% as of December 31, 2002), with all unpaid principal and interest due upon maturity on December 31, 2004.

6. Income Taxes

The Company's income tax provision consists of state minimum tax for the years ended December 31, 2002 and 2001.

At December 31, 2002, the Company had operating loss carryforwards to offset future taxable income of approximately \$658,000 and \$612,000 for federal and state tax purposes, respectively, which expire at various dates through 2022 and 2012, respectively.

The deferred tax asset at December 31, 2002 and 2001, of approximately \$269,000 and \$269,000, respectively, was fully offset by a corresponding valuation allowance because it is more likely than not, that recoverability of the asset would not occur. The major component of these temporary differences relates primarily to net operating loss carryforwards.

7. Related Party Transactions

Due from Affiliate

In September 2001 and as amended in 2002, the Company extended a line of credit to First American Dental Plan ("FADP"), a broker of the Company. The line of credit expires December 31, 2004, bears interest at prime plus 2%, and carries a maximum availability of \$95,000, exclusive of unpaid interest. Payments are received through deductions from monthly broker fees. The balance due at December 31, 2002 and 2001 was \$95,000 and \$22,331, respectively.

FADP is affiliated with the Company by a family relationship between the management of the two companies. Although for disclosure purposes the broker is considered an affiliate, the two companies operate separately and independently of each other. There exists no common managers, officers, directors or stockholders among the two companies.

7. Related Party Transactions (continued)

Commissions

Commissions for services rendered were paid to a certain stockholder of the Parent and the stockholder's spouse in the amount of \$14,679 and \$44,909, respectively, in 2002 and \$12,757 and \$38,525, respectively, in 2001.

Payable to Parent

As of December 31, 2001, the Company had \$4,500 due to its Parent for reimbursement of Company expenses that were paid on its behalf by the Parent. The amount was paid in full during 2002 and is included in accounts payable and accrued liabilities as of December 31, 2001.

8. Concentrations of Risk

Cash

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of temporary cash investments. The Company maintains its cash balances at financial institutions that management believes possess high-credit quality, and related cash balances are insured by the Federal Deposit Insurance Corporation up to \$100,000. At December 31, 2002, the Company had no amounts in excess of federally insured limits.

Premium Receivables and Premium Revenue

Premiums receivable represent unsecured amounts due from its members, and the Company is at risk to the extent that such amounts become uncollectible. The Company maintains allowances for estimated credit losses, which have generally been within management's expectations.

Approximately 25% and 46% of the Company's premium revenue during 2002 and 2001, respectively, and 68% and 75% of the Company's premium receivables as of December 31, 2002 and 2001, respectively, were derived from one broker. The remaining amounts were derived from individuals and smaller groups. No amounts are collected or due from third-party payors. No provider accounts for more than 5% of patient care services.

9. Commitments and Contingencies

Lease Commitments

In 2000, the Company commenced its lease of its primary facility in Santa Ana, California under an operating lease that expires in May 2005. The lease includes periodic rent increases based on amounts specified in the lease agreement, which have been recognized on a straight-line basis over the lease term.

The Company also leases equipment for a term of 51 months and has quarterly payments of \$339 through February 2005.

Rent expense under the above non-cancelable operating leases amounted to \$43,409 and \$33,795 in 2002 and 2001, respectively.

At December 31, 2002, future minimum lease payments under non-cancelable operating leases are as follows:

<u>Years ending December 31,</u>	
2003	\$ 42,798
2004	44,851
2005	<u>18,725</u>
	<u>\$ 106,374</u>

Regulatory Compliance

The Company is a specialized Health Care Service Plan licensed under the Act, which specifies that the Company maintain a minimum tangible net equity, as defined by the Act. At December 31, 2002 and 2001, tangible net equity was \$88,008 and \$66,605, respectively. The Company was in compliance with the tangible net equity requirement as of December 31, 2002 and 2001.

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Notes to Financial Statements (continued)

9. Commitments and Contingencies (continued)

Retirement Plan

Effective March 1, 2000, the Company established a Savings Incentive Match Plan for all employees (SIMPLE IRA) (the "Plan") that is subject to the requirements of the Employee Retirement Income Security Act of 1974. Employees of the Company are eligible to participate in the Plan upon receiving \$5,000 in compensation during each of the current and prior calendar years, as defined in the Plan document. Employees may elect to contribute a percentage of their compensation up to a maximum amount of the SIMPLE contribution limit, as defined by Internal Revenue Code Section 402. The Company currently contributes, up to three percent of the employees' salaries. Company contributions made to the Plan for the years ended December 31, 2002 and 2001 totaled approximately \$10,123 and \$6,693 respectively.